



May 1, 1997

EX PARTE OR LATE FILED

**EX PARTE**

William F. Caton  
Acting Secretary  
Federal Communications Commission  
1919 M Street, N.W., Room 222  
Washington, D.C. 20554

RECEIVED

MAY 1 1997

Dear Mr. Caton:

Re: CC Docket No. 96-45, Universal Service

Please associate this letter with the file in the above docket.

Proponents of the Hatfield Proxy Model are claiming in state regulatory proceedings that a statement in Pacific's January 24, 1997 Comments Regarding Staff Workshops on Proxy Cost Models supports their claim that forward looking expenses will be substantially lower than current expense levels. Our statement read as follows:

Moreover, despite charges that the BCPM's expense figures are not forward-looking and are based on purported ILEC "inefficiencies," the expenses actually represent only approximately 46% of the ARMIS accounts, even though local service investment represents approximately 66% of the ARMIS totals.

I attach a sample deposition transcript in which one of the Hatfield sponsors' experts, Robert A. Mercer, relies on the foregoing quotation to assert that the BCPM calculates total forward-looking costs as constituting only 46% of total actual costs. That claim is a gross distortion of our statement.

The statement in question does not address the relative comparison between current expenses and forward looking expenses. It simply notes that the proportion of a LEC's total forward looking *expenses* associated with local service is smaller than the proportion of a LEC's total forward looking *investment* associated with local service. Any attempt to draw from this statement some comparison between current expense levels and forward looking expense levels for a LEC across all of its services is not possible.

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Mr. William F. Caton  
May 1, 1997  
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Moreover, our quotation does not suggest that *all* forward-looking expenses or investment are captured in the 46% and 66% figures. Indeed, it conclusively states that they are not. The figures given only relate to expenses and investment for *providing local service*. Obviously, we have more expenses and investment than those associated with local service -- for example, the significant expenses associated with toll, private line and carrier access services. ARMIS captures not only expenses and investment associated with the local network, but with other parts of the network as well. Thus, it is not true that our *total* forward looking expenses and investments are only 46% and 66% of ARMIS.


We make this clarification not because the statement in question is inaccurate but because it is being deliberately misconstrued by the Hatfield sponsors.

We are also furnishing a copy of this ex parte to Regina Keeney, Kathleen Levitz, and Jeanine Poltronieri. We are submitting two copies of this notice in accordance with Section 1.206(a)(1) of the Commission's rules.

Please stamp and return the provided copy to confirm your receipt. Please contact me should you have any questions.

Thank you for your attention to this matter.

Sincerely,



Alan F. Ciamporcero  
Vice President  
Federal Regulatory Relations  
Pacific Telesis Group  
(A Subsidiary of SBC Communications, Inc.)

cc: R. Keeney  
K. Levitz  
J. Poltronieri

COPY

1

BEFORE THE WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION

DEPOSITION OF ROBERT A. MERCER  
March 18, 1997

IN THE MATTER OF THE PRICING ) DOCKET NO. UT-960369  
PROCEEDING FOR INTERCONNECTION)  
UNBUNDLED ELEMENTS TRANSPORT )  
AND TERMINATION, AND RESALE )

IN THE MATTER OF THE PRICING ) DOCKET NO. UT-960370  
PROCEEDING FOR INTERCONNECTION)  
UNBUNDLED ELEMENTS TRANSPORT )  
AND TERMINATION, AND RESALE )  
FOR U S WEST COMMUNICATIONS, )  
INC. )

IN THE MATTER OF THE PRICING ) DOCKET NO. UT-960371  
PROCEEDING FOR INTERCONNECTION)  
UNBUNDLED ELEMENTS TRANSPORT )  
AND TERMINATION, AND RESALE )  
FOR GTE NORTHWEST INCORPORATED)

Deposition location:  
555-17th Street, Suite 3200  
Denver, Colorado

APPEARANCES:

JOHN B. WILLIAMS, ESQ.  
BRIAN FARLEY, ESQ.  
COLLIER, SHANNON, RILL & SCOTT, PLLC  
3050 K Street, N.W.  
Washington, D.C. 20007

For GTE.

RAY V. HARTWELL, III, ESQ.  
HUNTON & WILLIAMS  
1900 K Street, N.W.  
Washington, D.C. 20006-1109

For GTE.

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BEFORE THE WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION

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UNBUNDLED ELEMENTS TRANSPORT )  
AND TERMINATION AND RESALE )  
FOR GTE NORTHEAST (INCORPORATED)

Deposition location:  
555-17th Street, Suite 300  
Denver, Colorado

APPEARANCES:

JOHN B. WILLIAMS, ESQ.  
BRIAN FARLEY, ESQ.  
COLLIER, SHANNON, RILL & SCOTT, PLLC  
3050 K Street, N.W.  
Washington, D.C. 20007

for GTE.

RAY V. HARTWELL, III, ESQ.  
MUNTON & WILLIAMS  
1900 K Street, N.W.  
Washington, D.C. 20006-1109  
For GTE.

The deposition of ROBERT A. MERCER,  
called for examination by GTE, was taken in the  
offices of Mollard and Hart, 555-17th Street, Suite  
300, Denver, Colorado, commencing at 8:57 a.m. on  
the 18th day of March, 1997, before Patricia M. Urede  
of Avery/Books Reporting Service, Inc., 1000 Spauld  
Boulevard, Denver, Colorado 80204, a Registered  
Professional Reporter and a Notary Public in and for  
the State of Colorado.

DANIEL WAGGNER, ESQ.  
DAVIS WRIGHT TREMAINE LLP  
1501 Fourth Avenue, Suite 2500  
Seattle, Washington 98101-1688

For AT&T.

ROBERT W. NICHOLS, ESQ.  
NICHOLS & HIGHT, LLC  
2050 Broadway, Suite 200  
Boulder, Colorado 80302

for MCI.

RICHARD FINNIGAN, ESQ. (BY TELEPHONE)  
Olympia, Washington

For Washington Independent  
Telephone Association.

ALSO PRESENT: FRANK MURPHY  
JAMES SQUAAR  
GREG CLINCK

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EXAMINATION BY MR. WILLIAMS  
EXAMINATION BY MR. FINNIGAN

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1 you want to --  
 2 A. I'm okay.  
 3 Q. Are you looking for some paper?  
 4 A. No, I'm just trying to get myself  
 5 organized better.  
 6 Q. You do know there that the \$4.26 that  
 7 is estimated in the Hatfield Model covers certain  
 8 discrete ARMS categories, correct?  
 9 A. Yes, it does.  
 10 Q. And do you know that the \$1.91  
 11 reflected in the CPM covers those exact same  
 12 categories?  
 13 A. You can't tell that specifically from  
 14 his representation, but I assume that again because  
 15 he's making the comparison that he had reason to  
 16 believe -- network operations is a well specified  
 17 category of expenses in ARMS.  
 18 Q. So when you compare these two numbers,  
 19 you were basing it on your assumption that it is an  
 20 apples to apples comparison?  
 21 A. I'm assuming that when he made an  
 22 apples to apples comparison he knew what he was  
 23 doing.  
 24 Q. So the answer to my question is yes?  
 25 A. Yes, I assume that's an apples to

1 So to the extent that we have looked at  
 2 a large amount of data such as this kind of testimony  
 3 to assess its validity, yes, it has had an impact on  
 4 the Hatfield Model.  
 5 Q. Have you made any changes upwards based  
 6 upon Mr. Scholl's testimony?  
 7 A. No, we have not.  
 8 Q. Just downward?  
 9 A. We have changed the one factor, network  
 10 operations, downward, that's right.  
 11 Q. Now, you have since adjusted downwards  
 12 based on Mr. Scholl's testimony to 50 percent, is  
 13 that right?  
 14 A. No, that was not based on Mr. Scholl's  
 15 testimony alone.  
 16 Q. Was it based at all upon Mr. Scholl's  
 17 testimony?  
 18 A. It was -- certainly the original belief  
 19 that it would be lower was Mr. Scholl's testimony.  
 20 There has been subsequent statements by Pacific Bell  
 21 about network operations that further substantiated  
 22 that this number said what it said and that it was  
 23 appropriate to further reduce the factor, but that  
 24 reduction was based more on the additional evidence  
 25 than it was Mr. Scholl's testimony.

1 apples comparison.  
 2 Q. Have you ever discussed that with  
 3 Mr. Scholl?  
 4 A. Only in an adversarial in the sense  
 5 that we've both been cross-examined about that issue.  
 6 Q. All right. Now, with respect to --  
 7 strike that.  
 8 You have relied upon this portion of  
 9 Mr. Scholl's testimony in the Hatfield Model, have  
 10 you not?  
 11 A. Yes.  
 12 Q. Have you relied upon any other portion  
 13 of Mr. Scholl's testimony here in the Hatfield Model?  
 14 A. Indirectly, yes, in the sense that this  
 15 evidence, as all evidence that has amassed during the  
 16 course of the arbitration proceedings, we have  
 17 carefully reviewed to see its impact on the Hatfield  
 18 Model.  
 19 Elsewhere in this testimony, for  
 20 instance, Mr. Scholl talks at great length about a  
 21 particular area of California, a town called Angel's  
 22 Camp, and made a comparison with the Hatfield  
 23 results. And we have analyzed that -- that analysis  
 24 to determine whether he was making legitimate  
 25 points.

1 Q. And the additional evidence you  
 2 provided today.  
 3 A. Yes, it is.  
 4 Q. So is it safe to assume, Dr. Mercer,  
 5 that the basis for the reduction now, network  
 6 operations, to 50 percent is based upon the  
 7 additional documentation that we received today?  
 8 A. It is Mr. Scholl's testimony, it's the  
 9 additional documentation, it's a comparison with the  
 10 cost -- the most recent version of the benchmark cost  
 11 model, the so-called benchmark cost proxy model, or  
 12 BCPM, that also has a lower number in it, so it's  
 13 really a third piece, although that ladder was really  
 14 more again a confirming piece of evidence, it was not  
 15 used as a basis for our conclusion. The conclusion  
 16 was based on these two documents.  
 17 Q. So the conclusion on the network  
 18 operations factor being based on two documents is  
 19 Mr. Scholl's testimony, Exhibit 4, and the new  
 20 document that you just gave us today, is that right?  
 21 A. Exhibit 4 is Scholl's? Yes, that's  
 22 correct.  
 23 Q. Let's look at that new document that  
 24 you gave us today and mark it as Exhibit 5.  
 25 (Whereupon, Deposition Exhibit 5 was

1 marked, for identification by the reporter.)

2 Q. Could you look at that, Dr. Mercer, or  
3 any other copy of the same document, and would you  
4 refer us to the portion that you are relying upon.

5 A. Yes, I'm looking at page -- I don't  
6 know how to do this. We see fax pages at the top.

7 If you count text pages, it's the  
8 first, second, third text page, and it's in a section  
9 that's titled The BCPM Contains Appropriate Inputs.

10 Q. Okay. And what portion of that are you  
11 relying upon?

12 A. I'm relying on the end of the first big  
13 paragraph under that topic, and in particular the  
14 last few sentences of that large paragraph.

15 Q. Okay. Could you read those sentences  
16 into the record, please, just the portion you're  
17 relying upon?

18 A. Yes. Moreover, despite charges that  
19 the BCPM's expense figures are not forward-looking  
20 and are based on purported ILEC inefficiencies, the  
21 expenses actually represent only approximately 46  
22 percent of the ARMIS accounts, even though local  
23 service investment represents approximately 66  
24 percent of the ARMIS totals. Regardless of how  
25 expenses should be modelled, the BCPM model will be

1 flexible enough to accommodate a variety of expense  
2 allocation theories.

3 Q. Could you tell me how that supports the  
4 reduction of network operations expenses to 50  
5 percent?

6 A. Yes. The -- this is a Pacific Bell  
7 cost -- this is a cost proxy model that Pacific Bell  
8 is sponsoring at this point, referred to again as  
9 BCPM, and in sponsoring that model and putting it  
10 forward as its model, it has said that the BCPM  
11 expense figures are only 46 percent of the ARMIS  
12 accounts, and based on that, our conclusion was that  
13 indeed when Mr. Scholl had said that the network  
14 operations was the same number -- incidentally, about  
15 Mr. Scholl's estimate, was that the -- that the cost  
16 proxy model showed 45 percent of ARMIS accounts; here  
17 he says 46 percent -- that that was a justification  
18 that their cost proxy model is estimating an amount  
19 that's 50 percent or thereabouts of the ARMIS  
20 accounts.

21 Q. Did you do any calculations based upon  
22 this statement here?

23 A. Yes. This statement you take 46 -- or  
24 you take in our case 50 percent and multiply it by  
25 network operations.

1 Q. No, no, no. I mean in order to  
2 determine the 50 percent factor. Did you just base  
3 it on this 40 percent -- excuse me, this 46 percent  
4 figure here, or did you do any calculations in view  
5 of other issues such as investment?

6 A. You do -- you do both really. You have  
7 this 46 percent figure, you have Mr. Scholl's 45  
8 percent figure, you have the network operations per  
9 line expenses of the telephone companies, many of  
10 which -- which vary considerably from one company to  
11 another but many of which are lower than that Pacific  
12 Bell number. It's really all -- it's all of the  
13 above.

14 But when you say what specific  
15 calculations, we didn't do any calculations beyond  
16 seeing what he has here.

17 Q. Let me clear this away. Are you  
18 interpreting this statement you just read to be  
19 Mr. Scholl's saying or Pacific Bell saying that  
20 network operations factor, forward-looking network  
21 operations factor, should be 46 percent of ARMIS  
22 reported data?

23 A. Yes.

24 Q. Okay. Thank you. Now, it's my  
25 understanding that the ratfield Model does another

1 calculation with respect to the forward-looking  
2 nature of the network operations, and there is a  
3 deduction made at some point for take-out service  
4 costs, cost of service.

5 A. I'm not sure what you're referring to.

6 Q. Well, I was confused based on the  
7 California testimony. You indicated that you started  
8 with the ARMIS data, then did a per line cost, and  
9 then -- and then removed costs from that category  
10 that were not associated with unbundled network  
11 elements.

12 A. There is an amount of network  
13 operations, that's right, that gets allocated to  
14 customer marketing and such accounts.

15 Q. Okay. And what percent of network  
16 operations is allocated to customer accounts?

17 A. I don't know.

18 Q. Is it someplace in the model?

19 A. No. It's calculated from the model  
20 itself once all of these expenses are determined.  
21 The customer operations is a small fraction of the  
22 total cost, so the number is small, but I don't know  
23 how large it is.

24 Q. And do you know who made that  
25 determination, how it was made, anything about that?

# TRANSCRIPT OF PROCEEDINGS

BEFORE THE  
WASHINGTON UTILITIES AND  
TRANSPORTATION COMMISSION

-----X  
: IN THE MATTER OF THE PRICING PROCEEDING: Docket Number  
: FOR INTERCONNECTION UNBUNDLED ELEMENTS : UT-960369  
: TRANSPORT AND TERMINATION, AND RESALE. :  
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: FOR U S WEST COMMUNICATIONS, INC. :  
: IN THE MATTER OF THE PRICING PROCEEDING: Docket Number  
: FOR INTERCONNECTION UNBUNDLED ELEMENTS : UT-960371  
: TRANSPORT AND TERMINATION, AND RESALE :  
: FOR GTE NORTHWEST INCORPORATED. :  
: -----X

## MERCER DEPOSITION EXHIBITS

Denver, Colorado

Tuesday, March 18, 1997

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1120 G Street NW  
Washington, D.C. 20005  
(202) 347-3700

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Before the  
FEDERAL COMMUNICATIONS COMMISSION  
Washington, D.C. 20554

In the Matter of

Federal-State Joint Board on  
Universal Service

CC Docket No. 96-45

## COMMENTS OF PACIFIC BELL REGARDING STAFF WORKSHOPS ON PROXY COST MODEL

### Summary

Pacific Bell makes the following points regarding the January 14-15, 1997 proxy model workshops:

The Commission's decision on proxy models is a critical one. However, proxy models are not a panacea. Models should not be used to size the universal service fund, because their forward-looking nature omits ILECs' legacy costs and actual, current costs. Rather, they should be used to disaggregate the fund to small units of geography once it is sized. We believe the Commission's forward-looking approach is causing potential facilities-based competitors to alter their plans to enter the market because the approach does not assure adequate cost recovery.

Any proxy model chosen should target support to small geographic units. The current Hatfield model fails to do this. The Benchmark Cost Proxy Model ("BCPM"), sponsored by Pacific Bell, U S West and Sprint, on the other hand, is capable of running and producing results at the Census Block level.

A proxy model's assumptions should be internally consistent.

The BCPM contains proper switch, expense and fill factor data.

### INTRODUCTION

Pursuant to Commission request,<sup>1</sup> Pacific Bell hereby submits comments regarding the staff workshops that occurred on January 14-15, 1997 on the subject of the use of cost proxy models in connection with the Universal Service docket. The cost proxy workshops held by the FCC on January 14 and 15, 1997, were well thought out, executed and delivered. Much valuable information was put on the record for the Commission to use in its analysis of the proxy models. Pacific Bell, along with its co-sponsors, U S WEST and Sprint, appreciated the opportunity to present their jointly-developed Benchmark Cost Proxy Model ("BCPM").

The decision of the Commission on the very important issue of proxy models will determine not only the compensation carriers will receive for services provided pursuant to the universal service mandate, but may also set the standard to which the network will be built in the future. The availability of affordable basic service in high cost areas will be impacted by the degree to which support provided by the model covers the cost carriers incur to provide that service. For these reasons, the selection of the model, the inputs into the model, and the outputs the model yields will have an impact on the evolution of local telecommunications markets and the development of competition in these markets.

The primary reason Pacific Bell developed proxy models was to allow for the targeting of high cost support. Today, we support affordable rates in our high cost areas in a number of ways: urban area rates are set higher than cost, business lines are priced higher than residence lines, custom calling features are priced well above costs, and access charges provide a positive contribution. The Telecommunications Act



of 1996 requires that this system of implicit support be replaced with specific, predictable, and sufficient explicit support. In order to make this change and size the fund correctly, high cost support needs to be carefully targeted only to those areas where it is actually needed.

It would be inappropriate to provide support based on statewide average costs or revenues from other services. Since most LECs keep their books and accounts at the Study Area level, it is critical to have a tool to allocate support to small geographic areas. This requirement led to the development of our initial proxy model, the Cost Proxy Model ("CPM") and to our collaboration with U S WEST and Sprint on the BCPM.

In its Recommended Decision, the Joint Board set forth eight criteria for an acceptable proxy model. As we outlined in our comments on the Joint Board's recommendation, we believe some of the criteria are faulty because they do not allow ILECs to recover their legacy costs, and do not adequately cover current, actual costs. However, assuming, arguendo, that the Joint Board's criteria are appropriate, the BCPM is the only model that meets each criterion and provides a workable framework for accurately targeting support.

A number of issues covered during the panel discussions merit special emphasis, since they are crucial to the decision the Commission must make over the next few months.

#### PROXY MODELS MAY BE USED TO DISAGGREGATE, BUT NOT SIZE, THE UNIVERSAL SERVICE FUND

Proxy models are essential to disaggregate to small units of geography, but not to size, the universal service fund. A forward-looking approach to sizing the fund ignores our actual, current costs and our legacy costs. If a forward-looking approach is used, it must be augmented with a recognition of the historical costs that regulators failed to let the ILEC recover. In the past, depreciation rates were set relatively low so that the basic rates could also be set low. This worked well in a regulated environment, where regulators had a commitment to making the company's investors whole. However, the Commission's commitment to making investors whole is now being threatened. This capital underrecovery must be recognized and subsidies set accordingly.

In addition, calculation of costs must be based on reasonable inputs and modeling. The actual expense of providing service in high cost areas must be covered to encourage competition and infrastructure build-out. Over the last several months we have watched the market react to the signals sent by various regulatory bodies, starting with the Commission's Interconnection Decision, and the reaction has been the opposite of what the Telecommunications Act of 1996 intended. During this period, both AT&T and MCI have announced significant rollbacks in their plans to build competing local networks. They have stated that they intend to enter the local markets primarily through resale of elements of the incumbents' networks. Most recently, Time Warner has announced a major scale-back in their local market entry plans, citing recent regulatory decisions as one of the reasons for their decision. Thus, in several months' time, billions of dollars of business plans to enter the local market have been shelved.

The Commission must heed the voice of the market. If the universal service fund does not provide carriers adequate reimbursement for their costs of serving high cost areas, the facilities-based competition the Commission seeks to promote will not come about.

#### A UNIVERSAL SERVICE MODEL SHOULD TARGET SUPPORT TO SMALL GEOGRAPHIC UNITS

The problem with the current universal service mechanisms is that they are, for the most part, implicit. Change is needed to move these implicit subsidies to explicit subsidies that are properly targeted to small geographic areas. The BCPM is capable of running and producing results at the Census Block level, although it currently has been filed at the (larger) CBG level. The extra granularity in the data from either the CB or the grid calculations correct many of the deficiencies in using CBG data, e.g., misassignment of customers to wire centers, miscalculation of distance, and erroneous assumptions of equal population dispersion within a CBG.

The Harfield model (version 2.2.2) does not produce results at the CBG level, and the Harfield developers have no plans to go down to the even smaller Census Block or grid levels. Thus, the Harfield model will be unable to disaggregate universal service funding to small enough geographic units to ensure some level

of accuracy in the level of costs the model produces. The Commission should not consider a model incapable of this level of specificity.

#### THE MODEL'S ASSUMPTIONS SHOULD BE INTERNALLY CONSISTENT

Assuming that a model is used at all, the model must have internally consistent assumptions if it is to produce accurate and realistic results. Since the Commission has required a forward-looking model that analyzes the cost of an efficient new entrant, the other model assumptions must also be forward-looking. Specifically, the capital costs used in the model must be based on the forward-looking cost of capital depreciation and future net salvage, and must be properly matched with the forward-looking expenses in the cost model. In a competitive marketplace, market share and customer retention issues increase the risk for telecommunications providers. This increased risk will cause the cost of capital to increase. For this reason, the cost of capital in a forward-looking competitive marketplace must be set higher than the 10% historical basis.

In addition, as the market becomes more competitive and technology changes more rapidly, the economic useful lives of assets will shorten markedly. This phenomenon has been seen in DCOs and CLEC depreciation rates. Based on 1995 results, the average life of plant for AT&T, MCI, NCS, and TCI is 10 years. This is well below the average of what has been used in any of the proxy models. Therefore, we recommend that the Commission set depreciation rates at a value that recognizes the risks inherent in a competitive marketplace.

#### THE BCPM CONTAINS APPROPRIATE INPUTS

As we explain below, the BCPM contains proper switch, expense data and full factor inputs.

The switch costs in the BCPM are not overstated. The Commission appears to support differentiation of switch costs between host and remote switches. However, in collecting the switch cost data, the BCPM team added the suppliers of the data to include the cost incurred at the host in the remote data. This altered the need to analyze both host and remote switch data. Moreover, the BCPM examines the average cost of switching for a customer in a given area. The BCPM model actually uses a switch curve for large companies; however, the BCPM can use three or more switch curves -- one for large companies, one for medium size companies, and one for small companies. However, if the Commission believes it necessary to verify these switch costs, we recommend that the Commission issue a data request to switch vendors. The vendors could then furnish data pursuant to the Commission's confidentiality provisions. In addition, the BCPM's expense data is accurate. A careful analysis of the data for those companies responding to our data request shows a close match between expenses and the number of lines. Moreover, despite charges that the BCPM's expense figures are not forward-looking and are based on purported "inefficiencies," the expenses actually represent only approximately 46% of the ARBIS accounts, even though local service investments represent approximately 66% of the ARBIS totals. Regardless of how expenses should be modeled (e.g., based on number of lines, investment, or some other criterion) the BCPM model will be flexible enough to accommodate a variety of expense allocation theories.

Finally, in regard to full factors, the Commission appears to be assuming that full factors should be set relatively high. However, the use of high full factors ignores the reality of growth, state mandated service requirements (e.g., that services be provided within a certain number of days), and customer churn. It is more cost effective to install more plant now rather than at a later date. Therefore, a lower full factor can result in a lower cost for the customer. In addition, the Commission appears to assume that a model should reflect a one-time build-out of the entire network. This assumption severely underestimates the true cost that efficient new entrants would face, since they would build plant in stages. To minimize costs and maximize efficiency, the Commission and the model's should support a staged build-out.

#### CONCLUSION

Proxy models are not a panacea. They are useful in disseminating cost information into small geographic markets but, at least as the Commission currently envisions them, they are not appropriate to sizing the fund. This task requires consideration of actual, current costs and BCP's legacy costs. The Commission's reliance only on forward-looking costs to size the fund repeats the error of its interconnection decision. Actual market activity indicates that such reliance is deterring entry by new facilities-based competitors.

Moreover, if proxy models are used, they must be used correctly. They must not -- as is the case with the current version of the Hatfield model -- contain internally inconsistent data. They must disaggregate the data to small geographic units; the BCPM does this, but the current version of Hatfield does not. We believe the BCPM represents the best approach to models, and urge the Commission to give it careful consideration.

Respectfully submitted,

PACIFIC BELL

MARLIN D. ARD  
SARA R. THOMAS

140 New Montgomery Street  
Room 1522A  
San Francisco, California 94105  
(415) 542-7649

MARGARET E. GARBER

1275 Pennsylvania Avenue, N.W.  
Washington, D.C. 20004  
(202) 383-6472

Its Attorneys

Date: January 24, 1997

1 See Public Notice, Federal-State Joint Board on Universal Service: Staff Workshops on Proxy Cost Models, DA 97-88 (rel. Jan. 15, 1997).

2 This argument does not alter our general opposition to forward-looking models. We are simply pointing out here that if the Commission insists on such a model, it must ensure that the model's inputs are internally consistent if the model's results are to have meaning.

3 See "The Use of Computer Models for Estimating Forward-Looking Economic Costs: A Staff Analysis," CCBP 97-2, DA 97-56 (rel. Jan. 9, 1997) at 6-7, 15 (suggesting using proprietary data with protective orders, in models).

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